

Internal Revenue Service
memorandum

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CPTello-Br6

date: DEC 20 1991

to: Mike Oleksiak
International Examiner

from: Chief, Br 6 CC:INTL:6

subject: [REDACTED]

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This memorandum confirms our oral advice concerning the sourcing of losses from the disposition of section 1256 contracts booked in the [REDACTED] branch. For the reasons discussed below, we believe that the losses should be treated as foreign source losses.

By telephone, you have indicated that [REDACTED] ([REDACTED]), a U.S. corporation, disposed of section 1256 contracts booked in its [REDACTED] branch in [REDACTED] at a loss. The contracts were futures of various foreign currencies. [REDACTED] treated the loss as a U.S. source loss on its [REDACTED] income tax return because the transactions with respect to the section 1256 contracts occurred in New York.

Section 865 (j) of the Internal Revenue Code provides that the Secretary shall prescribe regulations necessary for applying the rules of section 865 to income derived from trading in futures contracts, forward contracts, options contracts and other instruments. No regulations have been promulgated.

Although no regulations have been promulgated under section 865, several major statutory changes enacted by the 1986 Act should place [REDACTED] on notice that the losses from the disposition of the section 1256 contracts booked in [REDACTED] are foreign source losses.

First, section 865 (e) (1) provides that income of a U.S. resident not sourced under an exception to 865 that is attributable to a foreign office or other fixed place of business is foreign source income. A special rule requires that gain must be taxed by a foreign country at a ten percent rate in order for this rule to apply.

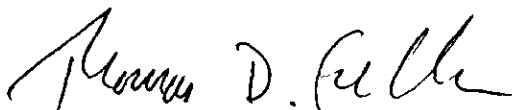
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This special rule is an anti-abuse rule that is not applicable to losses. The rule is designed to prevent taxpayers from artificially resourcing income as foreign source income in circumstances in which the foreign country does not tax the income and thereby avoid any tax on the income. The special rule has no application to losses. Taxpayers prefer U.S. source losses rather than foreign source losses because a foreign source loss has the effect of reducing the foreign tax credit that may be claimed. As a result, to apply the special rule to losses would be to transform the rule from an anti-abuse rule to a rule that would inappropriately provide a tax benefit. Accordingly, the Secretary was given broad regulatory powers to prescribe rules for losses under section 865 (j) (1). The draft regulations take the position that the special rule does not apply to losses.

The second change to the Code that is relevant is the addition of subpart J which prescribes rules for foreign currency transactions. These code sections incorporate the concept of a qualified business unit (QBU) that has similarities to the office or fixed place of business concept in section 865. Basically, a taxpayer computes the taxable income or loss separately for each QBU in its functional currency (section 987) and sources any foreign currency gain or loss attributable to certain foreign currency transactions according to the QBU on whose books, the asset, liability, or item of income or expense is properly reflected (section 988 (a) (3)).

For the above reasons, we have determined that the losses from the disposition of the section 1256 contracts by [REDACTED] in [REDACTED] should be sourced as foreign source losses.

Please telephone Carol Tello of this office at (202) 377-9493 if you have further questions.



THOMAS D. FULLER